TRENDS
IN FINANCIAL MANAGEMENT
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WorldCom Reforms Trump Sarbanes-Oxley

RICHARD BREEDEN, THE BANKruptcy court-appointed "corporate monitor" of MCI (formerly WorldCom), filed a report with the federal bankruptcy judge handling the MCI case in late August 2003 identifying 78 reforms MCI has agreed to. But the recommendations go "well beyond WorldCom," writes Breeden, a former chairman of the Securities & Exchange Commission. They're a "blueprint for action" that other public companies should adopt. Below is a snapshot of the report's accounting and finance recommendations. "Every recommendation…is applicable to any other company," Breeden reportedly said. See if you agree.

Accounting: Breeden lambastes "very aggressive accounting" that increases net income and pushes current profits to future earnings. He adds yet another voice critical of pro forma income reporting and improper acquisition accounting. He also criticizes accruals by "formula rather than actual results" for pension assets, "gain on sale" accounting for divestitures, and "mark-to-model" accruals of earnings on future performance contracts such as derivatives.

Cash Flow Reporting: The report says companies should enhance cash flow reporting to reflect accrued gains or losses that have not yet resulted in comparable cash flows. This goes beyond generally accepted accounting principles and SEC requirements, according to the report.

Dividend Policy: He instructs MCI to set the company's annual dividend payout to *at least* 25% of net income. Breeden is averse to retained earnings. Why? They make stock options more valuable. They enable larger-sized acquisitions to be financed without having to go to the public markets, which reduces "outside scrutiny and discipline on management decision making." WorldCom acquired 70 companies over two decades, many financed largely with WorldCom stock. By the late 1990s, Bernie Ebbers, WorldCom's then-chairman and CEO, boasted that deals were "essentially free."

Internal Audit: The audit committee of the board of directors should continuously oversee and review a company's internal audit program including a regular look at the "long-range work plan and risk assessments." The committee should also review the staffing levels and competence of internal auditors. Moreover, the internal audit department should report "for administrative purposes" to the CFO, but the CFO can't approve "internal audit's work plan." That should come from the audit committee.

Transparency Policies: Breeden wants companies to exceed the legal minimum requirements for disclosure. Lawyers, he writes, "are not generally capable of developing the best disclosure as it requires a grasp of financial drivers in the business" that lawyers typically don't have. Finance officials and internal lawyers should jointly develop "disclosure content" that provides the "best possible clarity and objectivity." Outside advisors can help, too. The company's standard should be what "the CEO, CFO, or outside auditor would want to know if they personally were investing in the company." He reminds us that "No law restricts extra disclosure."

Finance Department Staffing: In these recommendations Breeden may be refering only to MCI and not other companies per se. Your call. He writes: MCI "needs to accelerate and intensify its efforts to recruit senior-level finance, accounting, disclosure, and internal audit personnel…who have high levels of experience and skill" because there have been "weaknesses" in the existing staff for too long.

Risk Management: This is about having a risk management committee of the board of directors. Members of the risk management committee should have "significant experience in the identification, evaluation, or control of risk," the report says. The risk management committee should review the company's risk disclosures with special emphasis on management's identification, assessment, and management of all major risks.

The rest of the report, called "Restoring Trust," is primarily about reforming the board of directors, executive compensation, and legal and ethics programs. It can be found in its entirety at www.ragm.com/library/topics/Breeden_Restoring_Trust_Final-WorldCom082003.pdf.

Lawyers at Wachtell, Lipton, Rosen, & Katz don't agree with many of Breeden's recommendations. They wrote in a memo to clients that "Breeden's report is not really a 'blueprint' so much as an unfiltered laundry list of virtually all of the various types of reforms already considered at great length by everyone from Congress and the SEC to the stock exchanges."

The Breeden report said Ebbers became an "unrestrained force" who had "nearly imperial reign," which created the conditions for WorldCom's $11 billion fraud and bankruptcy, the largest in U.S. history. "One cannot say that the checks and balances…didn't work adequately," Breeden writes. "There were no checks and balances."

WorldCom initially reported $4 billion in accounting irregularities in the period leading up to Ebbers's forced resignation last year. But the total swelled to about $11 billion as the investigations progressed.

One of the abuses was the more than $400 million in so-called "loans" to Ebbers that were put in place initially by two directors who were long-time associates of Ebbers. "The loans, which are unlikely ever to be repaid…represented a nearly incredible action by a board that supposedly existed to represent shareholders, but in fact spent much of its time devising ways to enrich Ebbers," the report said. The board also allowed Ebbers to pay $238 million "retention" grants to favored executives and employees in a program that was "in effect a giant compensation slush fund," according to the report.

Eventually, the company's entire board was replaced, and virtually all of its senior managers were fired or forced into retirement.

The State of Oklahoma has filed criminal charges against Ebbers and five other people.

Previously, Breeden was a senior financial and domestic policy advisor to then-Vice President George H.W. Bush, who, as President, nominated Breeden chairman of the SEC. Breeden was SEC chairman from 1989 to 1993. He then joined Coopers & Lybrand as chairman of its worldwide financial services practice and in 1996 started his own consulting firm. ■